

SUBCOMMITTEE NO. 1 on Education



Subcommittee No. 1

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ITEM 6110 DEPARTMENT OF EDUCATION

ISSUE 1: Proposition 98 & K-12 Funding – Overview

DESCRIPTION: The LAO will summarize the Governor's budget proposal for Proposition 98 and K-12 education in 2006-07 and present their overall recommendations.

BACKGROUND:

Proposition 98- K-14

The Governor proposes **\$54.3 billion** in Proposition 98 spending for K-14 education in 2006-07, which reflects a **\$4.3 billion** increase (8.7 percent) over the revised 2005-06 budget. The Governor's K-14 proposal exceeds the Proposition 98 minimum funding guarantee by **\$2.1 billion** in 2006-07.

Table 2					
K-14 Proposition 98					
Summary (dollars in thousands)	2004-05	2005-06	2006-07 Proposed	\$ Change	% Change
<i>Distribution of Prop 98 Funds</i>					
K-12 Education	\$42,122,787	\$44,627,177	\$48,356,408	3,729,231	8.4
Community Colleges	4,792,007	5,242,136	5,848,062	605,926	11.6
State Special Schools	41,509	42,567	43,177	610	1.4
Dept. of Youth Authority	35,858	45,780	42,589	-3,191	-7.0
Dept. of Developmental Services	10,672	10,217	9,995	-222	-2.2
Dept. of Mental Health	8,400	13,400	13,400	0	0
Am. Indian Education Centers	4,476	4,698	4,322	-376	-8.0
Total	\$47,015,709	\$49,985,975	\$54,317,953	\$4,331,978	8.7
<i>Prop 98 Fund Source</i>					
State General Fund	\$33,994,860	\$36,310,868	\$40,455,466	\$4,144,598	11.4
Local Property Taxes	13,020,849	13,675,107	13,862,487	187,380	1.4
Total	\$47,015,709	\$49,985,975	\$54,317,953	\$4,331,978	8.7
K-12 Enrollment-ADA*	5,982,000	6,010,000	6,023,000		
K-12 Funding per ADA*	\$7,042	\$7,428	\$8,052	\$660	8.9
* Average Daily Attendance					

The Governor proposes **\$5.8 billion for community colleges** in 2006-07, which provides a **\$605.9 million** increase (11.6 percent) over the 2005-06 budget.

The Governor proposes **\$48.4 billion funding for K-12 schools** in 2006-07, an increase of **\$3.7 billion** (8.4 percent) above the 2005-06 budget. As proposed, the budget provides \$8,052 per-pupil in Proposition 98 funding in 2006-07, an increase of \$660 (8.9 percent) per-pupil above the 2005-06 budget.

Governor's Proposition 98 K-12 Proposals

The \$3.7 billion the Governor proposes for K-12 education in 2006-07 includes the following major base adjustments and program increases:

Programs/Dollars in Millions	2006-07
After School Care -- Proposition 49	\$426.2
Discretionary Funds:	\$2,700.0
(K-12 Enrollment Growth and COLAs)	(\$2,300.0)
(K-12 Revenue Limit Deficit Factor)	(\$205))
(K-12 Revenue Limit Equalization)	(\$200)
Annual Education Mandate Payments	\$133
New/Expanded Categorical Programs	\$413
TOTAL	\$3,700.0

Proposition 98 Minimum Guarantee – Current Year and Budget Year:

At the time the 2005-06 budget was enacted, Proposition 98 K-14 spending was assumed to be \$741 million above the minimum guarantee. Due to additional, unanticipated revenues to the state in 2005-06, the minimum guarantee has now risen. According to the Governor’s revenue estimates, the 2005-06 budget is now assumed to be **\$265 million** above the minimum guarantee.

The Governor’s Proposition 98 budget for 2006-07, which provides a \$4.3 billion increase for K-14 education, is assumed to be **\$2.1 billion** over the minimum guarantee. This funding above the minimum includes: **\$426 million** that must be appropriated above the minimum guarantee in order to implement the after school programs required by Proposition 49 in 2006-07 and **\$1.7 billion** to restore additional funding that would have been needed to meet the “Chapter 213 target” for suspension of the Proposition 98 minimum guarantee in 2004-05.

Of the **\$1.7 billion** the Governor proposes to meet the Chapter 213 suspension target, **\$561 million** is proposed to fully fund growth and COLA in 2006-07. Total growth and COLA is estimated at **\$2.3 billion** in 2006-07, however, this base funding adjustment cannot be fully funded without exceeding the minimum funding guarantee by an estimated \$561 million according to the Governor’s budget.

Maintenance Factor:

Maintenance factor is created in years when Proposition 98 is operating under Test 3 or years when the minimum guarantee is suspended. Maintenance factor is essentially the difference between the Test 2 level of funding and the actual funding level in these years. When Proposition 98 was suspended in 2004-05 it created **\$3.7 billion** in maintenance factor obligation, reflecting additional funding that would have otherwise been provided under the proposition under Test 2 that year.

Maintenance factor does not repay K-14 education for foregone funding in the year it was lost, but over time builds restoration of these funds within the Proposition 98 base calculation as revenues improve. Any funding provided above the minimum guarantee would also restore maintenance factor.

The Governor’s budget restores **\$2.4 billion** in outstanding maintenance factor to the Proposition 98 base in 2006-07, including: **\$334 million** of required restoration under the Proposition 98 formula; **\$1.7 billion** from the over-appropriation of funding for various K-12 base adjustments and new programs; and **\$426 million** in required over-appropriation for after-school programs pursuant to Proposition 49.

According to the Governor's budget proposals and revenue estimates, outstanding maintenance factor obligations would total **\$1.3 billion** at the end of 2006-07.

Proposition 98 Settle Up:

Chapter 216, Statutes of 2004 (SB 1108/Committee on Budget and Fiscal Review) appropriates **\$150 million** a year commencing in 2006-07 for Proposition 98 settle-up payments in several fiscal years over the period 1995-96 to 2003-04. The Governor proposes **\$133 million** in settle-up payments in 2006-07, since the 2005-06 budget provided a \$17 million pre-payment toward the budget year requirement.

Chapter 216 requires the Department of Finance and the Superintendent of Public Instruction to jointly determine the level of settle-up obligations for school districts and community colleges for the 1995-96 to 2003-04 period. As jointly determined, the Legislature was notified by DOF in January that Proposition 98 has been fully satisfied in all years during this period except 1995-96, 1996-97, 2002-03, and 2003-04. The estimated total outstanding Proposition 98 balance for these years is **\$1,400,590,000**.

Education Credit Card:

The Legislative Analyst has identified more than **\$2.9 billion** in K-14 education funding obligations it refers to as on the "education credit card" at the end of 2005-06. The Governor's proposes to buy down some of this debt in 2006-07, bringing the credit card down to **\$2.6 billion** at the end of the budget year.

The LAO provides the following table in their Budget Analysis that summarizes the education credit card in recent years and reflects the Governor's 2006-07 budget proposals. Under the Governor's proposals, outstanding credit card debt would total \$2.6 in 2006-07, including: **\$1.2 billion** in unpaid, cumulative mandate claim payment for K-14 education that have been deferred in recent years to achieve budget savings; **\$100 million** in K-12 revenue limit deficit factor payments to restore foregone COLA in 2003-04; and **\$1.3 billion** in various K-12 and community college payment deferrals that commenced in 2002-03 and shifted expenditures from one fiscal year to the next as a method of scoring budget savings.

In Millions	2003-04	2004-05	2005-06	2006-07
Deferrals				
K-12	\$1,097	\$1,083	\$1,103	\$1,103
Community Colleges	200	200	200	200
Subtotal, Deferrals	\$1,297	\$1,283	\$1,303	\$1,303
Mandates				
K-12	\$946	\$1,096	\$1,234	\$1,110
Community Colleges	55	73	91	109
Subtotal, Mandates	\$1,001	\$1,169	\$1,3235	\$1,219
K-12 Revenue Limit Deficit Factor	883	646	300	100
TOTALS	\$3,181	\$3,098	\$2,928	\$2,622

LAO Recommendations:

The LAO recommends a different approach to determining overall Proposition 98 funding in the budget year in order to address the state's structural budget gap and to protect schools and community colleges from cost pressures in the future. Specifically, the LAO recommends that the Legislature reject all proposals for new K-14 programs and essentially limit Proposition 98 funding to fully fund base

program costs in 2006-07. This recommendation would reduce Proposition 98 funding by **\$1 billion** below the level proposed by the Governor, while still providing a **\$3.3 billion** increase in Proposition 98 funding for K-14 programs in the budget year. The Governor's proposal and the LAO recommendations are summarized below.

<i>(Dollars in Millions)</i>	Governor's Budget	LAO Alternative	Difference
Baseline Adjustments			
Cost of living adjustment	\$2,566.8	\$2,873.7	\$306.9
Attendance	310.0	323.0	13.0
Mandates	133.6	173.0	39.4
Other	-96.9	-96.9	-
Subtotals	\$2,910.7	\$3,270.0	\$359.3
New and Expanded Programs			
	\$994.1	\$20	-\$974.1
Subtotals	\$994.1	\$20	-\$974.1
After- School Programs (Proposition 49)			
	\$426.2	0	-\$426.2
Subtotals	\$426.2	0	-\$426.2
TOTAL	\$4,311.0	\$3,290.0	-\$1,041.0
Amount Above Prop 98 Minimum Guarantee	\$2,100.0	\$1,100.0	

While equating to a net decrease of \$1.0 billion, the LAO recommends an increase of \$359.3 million to fully fund COLAs, declining enrollment adjustments, and annual mandate payments, as well as, reductions of \$974.1 million for new and expanded programs and \$426.2 million for after-school programs required by Proposition 49. (The savings proposed by the LAO for after-school programs would require repeal of Proposition 49 by voters for approval.)

The LAO's proposal would require an appropriation of **\$1.1 billion** above the Proposition 98 minimum funding guarantee compared to the Governor's proposal, which requires an over-appropriation of **\$2.1 billion** in 2006-07.

Other LAO Options: If the Legislature chooses to provide funding that is closer to the overall level of funding provided in the Governor's Budget for K-14 programs, the LAO has developed two additional funding options.

- **Option One: Use One -Time Funds to Address Settle-Up Obligations and Pay for Prior Year Mandates.** The LAO recommends the same level of funding as the Governor, but would replace **\$1 billion** in new, ongoing funding for new and expanded programs with \$1 billion in one-time funding to pay-down settle-up obligations and prior year mandate debts. Under this option the state could retire most of the **\$1.2 billion** in prior year mandate claims owed to K-14 education, and at the same time, reduce the **\$1.4 billion** in Proposition 98 settle-up obligations owed for prior years. Under current law, settle-up payments are scheduled at \$150 million a year for the next ten years to pay for prior year mandate claims. The LAO's proposal would pay these obligations sooner and therefore improve the state's long-term financial status by reducing future debt. In addition, a \$1 billion lump-sum payment would provide significant new, one-time resources to schools that could be used to address their most pressing fiscal issues.

- **Option Two: Target New Funds at Highest Local Needs.** Under this option, the LAO recommends eliminating **\$426 million** for after-school programs and returning the savings to the General Fund (this would require repeal of a ballot measure by voters). In addition, the LAO would redirect funding for new and expanded programs recommended by the Governor for the following alternative purposes that reflect more pressing needs of K-14 education: **\$388 million** for anticipated K-12 baseline growth and COLA increases (a component of all the LAO's recommendations); **\$412 million** for a Fiscal Solvency Block Grant for K-12 education to help districts and county offices address such pressures as declining enrollment and employee retirement and health costs; and **approximately \$130 million** for community college equalization.

SUGGESTED QUESTIONS: In assessing the Governor's overall Proposition 98 education package and the LAO's recommendations, the Subcommittee may want to consider the following issues and questions:

1. **Proposition 98 Funding Levels.** The Governor proposes a **\$4.3 billion** increase (8.7 percent) in Proposition 98 funds for K-12 school and community colleges in 2006-07. This assumes an over-appropriation of **\$2.1 billion** to fund all proposed expenditures.
 - *How did the Administration determine the level of overall funding for Proposition 98 funding in 2006-07?*
 - *How did the Administration determine what the state could afford to over-appropriate for K-14 education?*
 - *Could the over-appropriation proposed by the Governor lead to a situation where the state might need to suspend Proposition 98 in future years to close a structural budget gap?*
2. **Possible Changes in Proposition 98 Over-Appropriation Estimates.** The Administration estimates that Proposition 98 is over appropriated by **\$265 million** in the current year and **\$2.1 billion** in the budget year.
 - *How are the Administration's estimates of the Proposition 98 over-appropriation in the current and budget year likely to change in the coming months?*
3. **Maintenance Factor Payments.** The Governor proposes to pay off approximately **\$2.4 billion** of the estimated **\$3.8 billion** in outstanding Proposition 98 maintenance in 2006-07 (leaving \$1.3 billion remaining).
 - *The Administration includes the \$426 million in expenditures for After School programs required by Proposition 49 as maintenance factor payments in 2006-07. Can you explain the Administration's position on this decision?*
4. **Funding Existing Obligations Before Adding New Programs.** The Legislative Analyst's Office has identified approximately **\$2.3 billion** in outstanding obligations owed to K-12 schools, including prior year mandate claims and revenue limit deficits. The LAO refers to these debts as the education credit card. While the Governor proposes to pay down a small portion of this debt, the Governor is proposing more than **\$400 million** for new or expanded program initiatives and **\$200 million** for revenue limit equalization.
 - *What is the Administration's rationale for proposing to add funding for new, ongoing programs prior to paying off existing K-12 obligations?*

ISSUE 2: Major Adjustments – Enrollment Growth

DESCRIPTION: The Governor’s Budget estimates enrollment growth of 0.21 percent in 2006-07 and proposes **\$156.0 million** to fully fund enrollment growth for revenue limits and categorical programs.

BACKGROUND: The number of students in K-12 schools, as measured by unduplicated average daily attendance (ADA), is estimated to increase by 13,000 in 2006-07, an increase of 0.21 percent over the revised current-year level. This attendance increase will bring total K-12 (ADA) to 6,023,000.

Enrollment growth rates for the last five years are summarized below. Categorical programs receive enrollment growth at budgeted rates; revenue limit enrollment growth is adjusted to reflect actual rates.

Enrollment Growth Rates	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07 Proposed
Budgeted	1.45	1.40	1.37	1.34	0.95	0.69	0.21
Adjusted	1.53	2.06	1.66	0.88	0.97	0.47	

Statewide, year-to-year K-12 enrollment growth rates have been falling since the mid-1990’s when annual enrollment growth was budgeted at more than 2.5 percent. According to Department of Finance (DOF) figures, overall K-12 enrollment growth is predicted to decline to nearly zero in 2008-09, and after that is expected to start climbing again. The decline in growth rates reflects the loss of children born to “baby-boomers” who are aging out of the K-12 schools and a steady decline in birth rates during the 1990s.

Enrollment growth patterns play out quite differently for elementary schools and high schools than reflected by statewide trends overall. In particular, elementary school enrollment rates have been declining in recent years, while high school enrollment rates have been rising. However, in 2005-06 growth rates for elementary schools started to climb again and rates for high schools started to decline.

Enrollment trends also differ greatly among school districts. The LAO estimates that 438 school districts statewide are experiencing declining enrollments as a result of the drop in elementary school enrollments and other factors. This issue will be discussed further in the following agenda item.

The Governor’s Budget provides **\$156.0 million** to fully fund statutory enrollment growth for apportionments and categorical programs. The budget estimates K-12 ADA growth of 0.21 percent. The budget provides \$67.4 million for revenue limit apportionment growth and \$88.6 million for categorical programs. Additional breakdowns are provided below:

<i>Dollars in Millions</i>	Estimated Growth Rate	Revenue Limit	Special Education	Child Care	Other Categorical Programs	TOTAL Growth
Governor’s Budget	0.21%	\$67.4	\$6.5	\$14.8	\$67.3	\$156.0

COMMENTS: The Department of Finance will update enrollment growth estimates as part of the Governor’s May Revise to provide more up-to-date population estimates.

OUTCOME:

ISSUE 3: Major Adjustments – Declining Enrollment

DESCRIPTION: The Governor’s Budget includes **\$268 million** for revenue limit enrollment adjustments for school districts experiencing declining enrollment in 2006-07. The LAO estimates that declining enrollment adjustments will cost **\$343 million** in 2006-07 and recommends that the Legislature score an additional **\$75 million** for these adjustments.

BACKGROUND: Revenue limit funding is calculated by multiplying revenue limit rates for school districts times student enrollment, which is calculated by average daily attendance (ADA). Current law allows school districts that are experiencing declining student enrollment to *delay* revenue limit reductions associated with enrollment declines for one year. Declining enrollment districts can choose to use prior year enrollment as the basis of their revenue limit funding to soften the impact of enrollment based funding losses.

The LAO reports that a total of 438 school districts experienced declining enrollment in 2004-05 – the latest actual data available. As indicated in the previous item, K-12 attendance growth overall will continue to fall to near flat funding levels over the next several years, although growth rates will begin to climb again in 2009-10. For this reason, the LAO estimates that a large number of districts will continue to face declining enrollment

As the number of declining enrollment districts have risen, so too have the costs of declining enrollment revenue limit adjustments. As a result, the DOF recently started including estimates of declining enrollment adjustments in their annual revenue limit adjustments. The LAO developed the following table summarizing increases in the declining enrollment adjustments in recent years.

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Statewide Growth Rate	2.1%	1.7%	0.9%	0.4%	0.5%	0.2%
Districts Receiving Declining Enrollment Adjustment	327	375	412	438	Not Known	Not Known
Difference Between Prior Year ADA & Actual ADA for Declining Enrollment Districts	16,000	20,000	29,000	49,000	49,000	49,000
Costs of Declining Enrollment	\$74 m	\$93 m	\$137 m	\$242 m	\$255 m	\$268 m

The Governor’s Budget includes **\$268 million** for declining enrollment adjustments in 2006-07. In estimating these annual costs, DOF utilizes past-year costs adjusted for COLAs. According to the LAO, this methodology underestimated costs in 2004-05 – the most recent year with actual data – by approximately \$115 million.

The LAO recommends another methodology for determining declining adjustments given the growing size of the issue. The LAO recommends a methodology using the most current district-level attendance data and DOF long-term enrollment projections. Using this methodology, the LAO estimates that declining enrollment adjustments will cost **\$343 million** in 2006-07 and recommends that the Legislature score an additional **\$75 million** for these adjustments.

COMMENTS: The Department of Finance will update estimates of declining enrollment at May Revise.

OUTCOME:

ISSUE 4: Major Adjustments – Cost-of-Living Adjustments (COLAs)

DESCRIPTION: The Governor’s Budget provides **\$2.3 billion** to fully fund statutory COLAs for K-12 revenue limits and categorical programs in 2006-07. This provides a 5.18 percent COLA for revenue limits and categorical programs. The LAO estimates that COLA will increase by 5.8 percent in 2006-07 using more current indicators of inflation than available when the budget was developed. The higher COLA rate would increase K-12 COLA expenditures by **\$273.3 million** above the Governor’s Budget.

BACKGROUND: K-12 education programs typically receive annual COLAs for all revenue limit programs and most categorical programs, as required by statute. Budgeted COLAs for the last five years are summarized below. During this period, there was only one year -- 2003-04 – that the budget did not fund COLAs for revenue limits and categorical programs. The budget estimated COLA at 1.9 percent that year. In contrast, the 2002-03 budget provided a 2.0 percent COLA, which was higher than the estimated rate of 1.66 percent.

COLAs Rates	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07 Proposed
Budgeted	3.17	3.87	2.0	0	2.41	4.2	5.18
Estimated	3.17	3.87	1.66	1.86	2.41		

The Governor’s Budget proposes **\$2.3 billion** to fully fund statutory COLAs for K-12 revenue limits and categorical programs. The Governor estimates a 5.18 percent COLA, which provides \$1.7 billion for revenue limits and \$594.2 million for categorical programs that either require a COLA pursuant to state statute or tradition. The table below provides additional breakdowns of COLA adjustments for revenue limits and some categorical programs.

<i>Dollars in Millions</i>	Estimated COLA Rate	COLA \$: Revenue Limit	COLA \$: Special Education	COLA \$: Child Care	COLA \$: Other Categorical Programs	COLA \$: TOTAL
Governor’s Budget	5.18%	\$1,689.3	\$161.6	\$70.2	\$364.4	\$2,283.5

COMMENTS: The Department of Finance will update COLA estimates as part of the Governor’s May Revise to reflect inflation updates. The LAO estimates that COLA rates will increase by 5.8 percent in 2006-07 -- higher than the 5.18 percent estimated by the Governor – and will therefore increase COLA expenditures by **\$273.3 million** above the Governor’s Budget level.

[Budget Trailer Bill Language]

OUTCOME:

ISSUE 5: Major Adjustments – Revenue Limit Deficit Factor

DESCRIPTION: The Governor’s Budget proposes **\$205 million** to restore roughly two-thirds of outstanding revenue limit deficit factor obligations in 2006-07, leaving approximately \$100 million in remaining obligations to K-12 schools. Of this amount, the Governor’s Budget proposes \$200 million for school districts and \$5 million for county offices of education. This augmentation reduces deficit factors to 0.3 percent for school districts and 0.1 percent to county offices of education.

BACKGROUND: The Legislature has approved deficit factors for revenue limits in years when the statutory COLA has not been fully provided, or more recently due to revenue limit reductions. Deficit factors reduce base revenue limits by a percentage tied to the level of the reduction or foregone COLA, compared to the other amount otherwise required by statute. During the early 1990’s, when the statutory COLA for revenue limits was not fully funded, deficit factors were as high as 11 percent. It took nearly 10 years for the state to eliminate these deficit factors and restore base revenue limits. (Buy-out was completed in the 2000-01 budget.)

As indicated below, the 2003-04 budget suspended the 1.8 percent COLA for revenue limit programs and reduced revenue limit funding by 1.2 percent, which resulted in approximately \$900 million in savings. Budget trailer bill language contained in AB 1754 (Chapter 227; Statutes of 2003) created a 3.0 percent deficit factor for these revenue limits reductions and foregone COLA’s that would be restored to revenue limit calculations in subsequent years.

	2003-04	2004-05	2005-06	2006-07
Deficit for Revenue Limit Reduction	1.2 %	.3%	0	
Deficit for Foregone Revenue Limit COLA	1.8%	1.8%	1.1%	
Total Outstanding Revenue Limit Deficit	3.0%	2.1%	1.1%	0.3 % -- School Districts 0.1% -- County Offices of Ed.
Deficit Factor Balance	\$833 m	\$646 m	\$305 m	\$100 m

The 2004-05 budget provided \$270 million to reduce the deficit factor for revenue limits from 3.0 percent to 2.1 percent. The 2005-06 budget provided an additional \$406 million for deficit factor reduction, bringing the total deficit factor down to 1.1 percent.

In 2006-07, the Governor’s Budget proposes an additional **\$205 million** to restore approximately two-thirds of the outstanding deficit factor, currently estimated at \$305 million, leaving \$100 million in remaining deficit factor. Of this amount, the Governor proposes \$200 million for school districts and \$5 million for county offices of education. This augmentation translates differently for LEAs reducing deficit factor to 0.3 percent for school districts and 0.1 percent for county offices of education.

COMMENTS: The LAO recommends that the Legislature redirect the \$206 million for revenue limit deficit reduction to pay for the increased cost of a higher COLA in 2006-07. As noted in the previous agenda item, the LAO estimates \$273.3 million in COLA costs above the Governor’s Budget levels.

[Budget Trailer Bill Language]

OUTCOME:

ISSUE 6: Major Adjustments -- Revenue Limit Equalization

DESCRIPTION: The Governor proposes a **\$200 million** increase in funding to equalize school district revenue limits. The Administration estimates that the additional \$200 million would move the state half way toward fully meeting the state's equalization target. The Governor's proposal does not include revenue limit equalization for county offices of education. The 2004-05 budget appropriated \$110 million for revenue limit equalization, using similar calculations now being proposed by the Governor.

Background: Revenue limits are calculations intended to provide the same level of general purpose funding to school districts and county offices of education. However, some differences in revenue limit funding levels exist because of historical factors. The Administration proposes to continue the recent methodology to level up lower revenue limit districts until the state achieves equity for 90 percent of the state's ADA by size (large and small districts) and type (unified, high school, and elementary). Some extremely high revenue limit districts would continue to receive a higher revenue limit.

The 2004-05 budget package provided \$110 million for K-12 revenue limit equalization funding for school districts (not county offices), setting the target at the 90th percentile of districts within each size and type of district. The Governor did not propose additional funding for equalization in 2005-06.

The Governor proposes to add another \$200 million for revenue limit equalization in 2006-07, using a similar methodology utilized in 2004-05. The Governor's revenue limit equalization proposal is contained in two identical bills -- **SB 1358 (Simitian)** and **AB 2070 (Daucher)** – that continue the current statutory process for computing revenue limit equalization.

Two other bills that address equalization this session include:

- **SB 1689 (Perata)** – Replaces the average daily attendance with average monthly enrollment as the basis for computing revenue limits and school apportionments.
- **AB 60 (Nunez)** - Revises computation factors of revenue limit equalization adjustment to be based on the following: (1) enrollment instead of ADA and; (b) elementary, high school, and unified districts without respect to size; and (c) all unrestricted funding including revenue limit add-on programs, not just base revenue limits.

The LAO has supported revenue limit equalization in the past as a means of making base revenue limit funding more uniform among districts. However, given the difficult fiscal situation faced by many school districts in the state, including those that would not qualify to receive equalization funding, the LAO recommends that the Legislature delay equalizing revenue limits to future years. In addition, the LAO recommends that the Legislature redirect the proposed \$200 million for equalization to address fiscal solvency issues in school districts. (School district fiscal solvency issues will be discussed at the Subcommittee's April 24th hearing.)

Other Revenue Limit Adjustments and Add-On Programs: Revenue limit apportionment programs are made up of both base revenue limits, which account for approximately 95 percent of revenue limit funding; and revenue limit add-on programs and adjustment, which account for the remaining 5 percent. According to the LAO, these revenue limit add-on programs are allocated very unevenly among districts and contribute to revenue limit funding inequities among school districts. However, they are not included in revenue limit equalization calculations.

If the Legislature pursues revenue limit equalization in 2006-07, the LAO recommends changing the current methodology by including several revenue limit add-on programs and adjustments within the revenue limit base. Specifically, the LAO recommends that four revenue limit add-on programs -- Meals for Needy Pupils, SB 813 Incentive Grants, Unemployment Insurance, and PERS Reduction -- be consolidated into base revenue limits to more accurately equalize general purpose funding among school districts. In addition, the LAO recommends that several inter-district adjustments that provide general purpose funding to six school districts be added to the revenue limits prior to equalization.

OUTCOMES:

ISSUE 7: Education Mandates –Annual Payments (6110-295-0001)

DESCRIPTION: The budget proposes to restore annual funding for K-12 education mandates and to stop the recent practice of deferring or suspending all funding for education mandates. Specifically, the Governor proposes to provide **\$133.6 million** to cover the annual costs of state-mandated local education programs for K-12 school districts and county offices of education in 2006-07. The LAO recommends augmenting this amount by **\$28.2 million** to more fully fund the annual cost of K-12 education mandates in the budget year.

BACKGROUND: After 2001-02, funding for education mandates costs basically stopped, and payments were deferred to future years or suspended. This action was taken to reduce expenditures given the fiscal circumstances that year and in subsequent years. By deferring reimbursement of mandate claims, the state is not eliminating its obligations. The state must eventually pay all claims, once audited and approved. The state must also pay interest on overdue claims, based upon the rate established for the Pooled Money Investment Account. According to the LAO, the state has paid \$48.6 million in interest on the unpaid mandates through 2002-03, as last estimated.

The Governor proposes to provide **\$133.6 million** to cover the annual costs of 39 mandated education programs for K-12 school districts and county offices of education and for community colleges in 2006-07. The Governor's proposal reverses the practice in recent years of deferring or suspending annual mandate payments to achieve short term budget savings. Total mandated costs for K-12 education are estimated by DOF at **\$161.8 million** in 2006-07. (This amount does not include \$4 million for PERS mandates for K-12 schools and community colleges.) Under the Governor's proposal, if \$133.6 million is insufficient to cover all eligible claims for the year, the amount allocated to districts will be prorated by the State Controller.

The Budget does not include funding for either the State Testing and Reporting (STAR) program or the School Accountability Report Card (SARC) based upon recent decisions by the Commission on State Mandates (CSM). Specifically, the CSM recently ruled to eliminate most STAR reimbursements and to eliminate all SARC reimbursements. The Governor also proposes to continue suspension of several mandate programs mandates in 2006-07, including: School Crimes Reporting II; School Bus Safety I & II; Law Enforcement Sexual Harassment Training; County Treasury Withdrawals, and Grand Jury Proceedings.

COMMENTS: The LAO supports the restoration of annual funding for education mandates as a part of the base budget, but recommends that funding be increased by **\$28.2 million** in 2006-07 to fully fund estimated costs. The LAO also recommends that the Legislature schedule funding for individual mandates in the budget bill – as was the previous budgeting practice -- so that it is clear which mandates are being funded annually.

STAR mandated reimbursements will be discussed in more detail later in the hearing agenda.

OUTCOME:

ISSUE 8: Education Mandates – Prior Year Payments

DESCRIPTION: The Governor proposes to provide **\$151.7 million** in one-time funds – **\$18.7 million** from the Proposition 98 reversion account and **\$133.2 million** in Proposition 98 settle-up funds – to pay for prior year education mandate claims. The state currently owes an estimated **\$1.2 billion** in unpaid, education mandate costs for K-12 education according to the LAO.

BACKGROUND:

The Legislative Analyst's Office estimates that the cumulative costs for unpaid, prior-year claims will total **\$1.2 billion** for K-12 schools and community colleges by the end of 2005-06. The state must eventually pay all claims, once audited and approved. The state must also pay interest on overdue claims, based upon the rate established for the Pooled Money Investment Account.

Chapter 216, Statutes of 2004 (SB 1108/Committee on Budget and Fiscal Review), the 2004-05 education budget trailer bill, requires the state to begin appropriating **\$150 million** a year beginning in 2006-07 for Proposition 98 settle-up repayment and specifies that any such funds must first be applied in satisfaction of unpaid mandate claims.

Chapter 216 requires the Department of Finance and the Superintendent of Public Instruction to jointly determine the level of settle-up obligations for school districts and community colleges for the 1995-96 to 2003-04 period. The estimated total outstanding Proposition 98 balance for these years is **\$1.4 billion**.

The Governor also proposes to provide **\$151.7 million** in one-time funds – \$18.7 million from the Proposition 98 reversion account and \$133.2 million in Proposition 98 settle-up funds – to pay for prior year education mandate claims. The \$133.2 million in settle-up funds would be allocated to K-12 school districts and county offices of education – not community colleges -- on the basis of payment for the oldest claims first. It is not clear how the \$18.7 million would be allocated for prior-year claims.

COMMENTS: The LAO considers accumulated mandate cost deferrals to be the largest item on the state's education credit card, and generally recommends that the Legislature pay off these debts before funding new programs. However, the LAO recommends major reforms to funding state-mandated local education mandates that would affect how the state pays for the estimated \$1.2 billion in unpaid, prior year claims for K-12 education. These reforms are discussed in an upcoming hearing agenda item.

[Budget Trailer Bill Language]

OUTCOME:

ISSUE 9: Education Mandates – New Mandates

DESCRIPTION: In fulfillment of their statutory responsibility, the LAO has reviewed four new education mandates included in the Commission of State Mandates annual report of new mandates. The LAO recommends approval of these four new mandates, which include: Pupil Promotion and Retention, Differential Pay and Reemployment, Teacher Incentive Program, and AIDS Prevention Instruction II.

BACKGROUND: The LAO was given responsibility for reviewing and commenting on newly identified mandates pursuant to Chapter 1124, Statutes of 2002 (AB 3000/Committee on Budget). Pursuant to this responsibility, the LAO recommends that the Legislature recognize four new education mandates in the budget that were by the Commission on State Mandates in their annual report of newly identified mandates.

These four new mandates, as summarized below, include: Pupil Promotion and Retention, Differential Pay and Reemployment, Teacher Incentive Program, and AIDS Prevention Instruction II. The Commission on State Mandates estimates costs for these mandates would total \$10.8 million through 2005-06. Annual costs for these mandates are estimated by the Department of Finance to total \$17.3 million beginning in 2006-07. These four mandates are included in the Governor's 2006-07 annual mandate claims budget item.

New Mandates Approved by The Commission on State Mandates in 2005 <i>(In Millions)</i>			
Mandate	Requirement	Accrued Costs Through 2005-06	Estimated Cost in 2006-07^a
Pupil Promotion and Retention	Provide academic instruction to students at risk of failure.	\$10.4	\$17.3
Differential Pay and Reemployment	Implement policies for employees who exhaust sick leave.	0.2	-- ^b
Teacher Incentive Program	Administer state awards for earning national teaching certification.	0.1	-- ^b
AIDS Prevention Instruction II	Plan and conduct in-service training for teachers.	0.1 ^b	-- ^b
Totals		\$10.8	\$17.3
^a Department of Finance estimate. ^b Less than \$50,000.			

COMMENTS: The LAO recommends approval of these four new mandates identified by the Commission on State Mandates and included in the Governor's 2006-07 budget. The LAO notes that ongoing costs could change since they are based on prior year claims data and participation rates, which could be different in the future.

OUTCOMES:

ISSUE 10: Education Mandates – STAR Mandates

DESCRIPTION: The LAO makes several recommendations regarding funding for the State Testing and Reporting (STAR) mandate in response to recent action by the Commission on State Mandates regarding this assessment program mandate. Specifically, the LAO recommends a new methodology for reimbursing STAR claims that would require an additional **\$11.2 million** in ongoing funds for STAR mandates and **\$104.5 million** in one-time funding to retire outstanding STAR mandate obligations.

BACKGROUND:

Chapter 216, Statutes of 2004 directs the Commission on State Mandates (CSM) to reconsider an earlier decision on the STAR program mandate in light of federal testing requirements for states that applied when the STAR program was enacted. As a result of their recent decision, the CSM defines a limited number of STAR activities that are allowable for purposes of claims reimbursement. Specifically, the CSM made the following findings:

- The norm-referenced assessment – which has been recently scaled back to include third grade and seventh grade tests – is the only reimbursable mandate because it is not required by federal law.
- The California Standards Test (CST) – which applies to most grades -- is not a reimbursable mandate because districts failed to submit a mandate test claim for this test.
- The Primary Language Test for English learner students is not a reimbursable mandate.

In response to these findings, the Governor’s Budget assumes there are no costs for the program and provides no ongoing funding for the STAR mandate in 2006-07.

The CSM limited its recent review to 2005-06 claims and did not review prior year claims totaling \$220 million. The CSM felt that review of prior year claims was not authorized by the Chapter 216 language. According to the LAO, this limited review, together with the commission’s findings, leave many unanswered questions for settling prior year claims and determining fair and reasonable ongoing costs for the STAR program.

For these reasons, the LAO recommends that the Legislature adopt a new methodology that would enable the state to settle prior year claims and cover current costs, while focusing on state-only STAR mandates. The LAO’s recommendations build upon authority in Government Code Section 17518.5 allowing the state to establish a “reasonable reimbursement methodology” that simplifies the claims process and addresses actual costs. The LAO recommends a specific methodology, based on the average per-pupil testing costs for prior year claims and the proportion of tests required only by state law. The LAO’s formula generates the following costs:

- **\$11.2 million** in ongoing STAR mandate funding for districts participating in settlement, although after several years funding would be folded into the STAR appropriation item.
- **\$104.5 million** in one-time funding for prior-year STAR mandate claims provided as a part of the \$151 million the Governor proposes for other prior- ear mandates in 2006-07.

OUTCOME:

ISSUE 11. Education Mandates – Truancy Mandates

DESCRIPTION: The LAO recommends eliminating two state-mandated local truancy programs and redirecting **\$16.9 million** in mandate funding for these programs in order to create a new categorical program aimed at reducing student truancy and dropout.

BACKGROUND: Under current law, students are defined as truant if they are absent from school or classes without permission three times during the school year. The Governor's budget includes **\$16.9 million** in the education mandates budget item for truancy programs that require schools to notify or meet with parents of students who are truant. Funding for these two state-mandated local programs, as specified below, is based upon DOF estimates for claims in 2006-07:

- **Truancy Notification Mandate (\$9.8 million).** This mandate requires schools to notify parents of truant students by mail or other reasonable method. Districts receive \$15.40 for every notification made pursuant to this mandate.
- **Habitual Truant Mandate (\$7.2 million).** This mandate requires schools to “make every effort” to meet with the parents of habitual truants -- defined as students who are absent from school – without permission -- five or more times a year.

The LAO conducted a review of these truancy mandate programs and identified several problems that are felt to undermine their effectiveness in addressing truancy and dropout prevention.

- **Mandates can create the wrong incentives.** Under the Truancy Notification mandate districts receive \$15.40 in reimbursement each time they notify parents of student truancy. This unit-cost reimbursement creates incentives for districts to simply maximize parent notifications rather than addressing truancy prevention.
- **Implementation is uneven.** Claiming for truancy mandates programs plays out very differently among participating school districts and does not appear to correspond to measures of the truancy problem in these districts.
- **Funds are not targeted to districts with the greatest problems.** In addition to uneven funding, the claiming process does not allocate funding to the districts based upon the severity of their truancy problems

As a result of these findings, the LAO recommends another approach to truancy and dropout prevention. Specifically, the LAO recommends that the Legislature eliminate the two existing truancy mandate programs and redirect \$16.9 million in funding from these programs to a single, new truancy categorical program aimed at truancy prevention. The new program would provide \$16.9 million in grants to school districts based upon the number of students who dropout annually. Districts could use funds for a number of purposes, including (1) identifying students who are at-risk of dropping out in high school or falling behind in class work; (2) contacting students' parents; and (3) developing individual student plans to address specific barriers to their progress in school.

OUTCOME:

ISSUE 12. Education Mandates – LAO Reforms to the Mandates Process

DESCRIPTION: The LAO has identified a number of problems with the state's current method of funding state-mandated local programs in K-12 education. As a result, the LAO recommends major reforms to the state's system. Specifically, the LAO recommends that the Legislature create an Educational Mandate Block Grant program to simplify the financing of K-12 mandate programs and improve the distribution of mandate reimbursements to districts.

BACKGROUND: The LAO believes that funding for state-mandated local programs may be one of the most contentious issues in K-12 education finance. According to the LAO, the lack of annual funding in recent years is only one part of the education mandates problem. The LAO identifies several major problems with the system:

- Mandates are often not the most effective financing mechanism.
- The process for identifying new mandates is a lengthy and legalistic.
- The claiming process requires significant state and local administrative effort.
- The audit process increases friction between the state and districts.

As a result of these findings, the LAO recommends a new approach to education mandates funding. The State Constitution requires the state to pay districts for the actual costs of complying with state mandates. In recognizing this obligation, the LAO's proposal is framed as two basic options for funding 39 different K-12 mandates for schools districts:

Option One: Districts could continue to submit separate claims for all K-12 mandates; or

Option Two: Districts could accept block grant funding as adequate reimbursement to cover all K-12 mandates.

Features of the LAO's proposed Education Mandate Block Grant include:

Per Pupil Funding: Districts would receive approximately \$27 per pupil in mandate reimbursements based upon the DOF estimate of full funding of 2006-07 mandate costs. If the Legislature adopts the LAO's recommendation to redirect funding for two truancy mandates to a new categorical program, funding for the block grant would drop to \$24 per pupil. The LAO's proposal would also maintain \$4 million outside the block grant to pay for two PERS mandates.

No Audits of Block Grant Claims. Districts would not be required to account for the individual costs of each of the 39 mandates if they received the block grant. While districts would be reviewed periodically to ensure they are providing mandated activities, they would not be subject to financial audits for costs covered by funds in the block grant.

New Mandates Incorporated into the Block Grant. The per pupil block grant amount would be adjusted annually through the budget process to reflect new mandates approved by the Commission on State Mandates.

OUTCOME:

ISSUE 13: Federal Funding Overview

DESCRIPTION: The Governor's Budget estimates that California will receive **\$7.1 billion** in federal funds for K-12 education in 2006-07, which represents a small increase of \$12.2 million (0.2 percent) in the budget year. However, the Department of Finance has not yet updated its federal fund estimates to reflect reductions in federal funding enacted in late December 2005 as a part of the federal budget package for federal fiscal year (FFY) 2006. **Initial estimates from the federal government indicate that federal education funds will decrease by approximately \$154 million (3.5 percent) overall in 2006-07.** This includes small reductions for most programs and significant reductions for five programs. While some of these reductions can be mitigated by available federal carryover balances, other reductions will result in program losses to California schools.

BACKGROUND: Of the **\$7.1 billion** in federal funds proposed in the Governor's Budget for the California Department of Education, **\$7.0 billion** is appropriated for local assistance programs and **\$152 million** is appropriated for state operations in 2006-07.

The \$7.0 billion in federal funds for CDE in the Governor's Budget is appropriated from three major federal agencies – the U.S. Department of Education, U.S. Department of Health and Human Services, and the U.S. Department of Agriculture. Four specific federal programs – child nutrition (school meals); Title I (compensatory education); child development (child care); and special education – provide the most federal funding to K-12 schools in California. These four programs are among the largest federal programs -- of any type -- to our state. The table below reflects federal local assistance funds for these and other programs included in the Governor's Budget for 2006-07. Figures are based upon appropriations for federal fiscal year (FFY) 2006.

Federal Funds -- Agency/Program	FFY 2006
<i>US Dept. of Education:</i>	
Title I and Other Programs Authorized Under NCLB	2,981,115,000
Special Education – IDEA	1,162,810,000
Vocational & Adult Education, Tech. Prep. Education – Perkins & WIA	205,672,000
Other –Various	31,591,000
<i>Subtotal, USDE Funds</i>	<i>\$4,381,188,000</i>
<i>US Dept of Agriculture:</i>	
School Nutrition – School Lunch, Breakfast, Summer Meal Programs	\$1,638,079,000
<i>Subtotal, USDA Funds</i>	<i>\$1,638,079,000</i>
<i>US Dept of Health & Human Services:</i>	
Child Care – TANF & Child Care and Development Block Grant	\$935,707,000
<i>Subtotal, USHHS Funds</i>	<i>\$935,707,000</i>
<i>Total, Federal K-12 Education Grants to California</i>	<i>\$6,954,974,000</i>

The Department of Finance plans to update these figures at May Revise to reflect new amounts in the federal Labor, Health and Human Services (HHS) and Education appropriations bill (P.L. 109-149) and the government-wide rescissions bill (P.L. 109-148) for FFY 2006 that were both signed by the President on December 30, 2005. The rescissions bill enacted a one-percent, across-the-board reduction for federal discretionary programs.

In early February, the U.S. Department of Education released estimates of education grants to states reflecting new FFY 2006 appropriations. These new estimates, which are listed below, include funding

reductions for most federal programs in our state. Overall, grants to California will decrease by **\$154 million** or 3.5 percent in 2006-07 (FFY 2006). These reductions have not yet been included in the Governor's Budget and stand in sharp contrast to federal funding increases in recent years. While federal funding increased by only one percent overall in FFY 2005, between FFY 2001 and FFY 2004 federal education funding to California grew between 8 and 12 percent annually. (See Appendix A. for latest federal estimates of USDE formula grants to California for FFY 2001 to 2007.)

Federal Local Assistance Grants to California

Budget Item	Program	FFY 2005	FFY 2006	Change
6110-				
102-0890	Learn and Serve America	2,636,926	2,690,544	53,618
103-0890	Byrd Honors Scholarship	5,139,000	5,127,000	-12,000
112-0890	Charter Schools	25,107,664	25,125,104	17,440
113-0890	State Assessments	33,952,540	33,952,540	0
119-0890	Title I (Part D) - Neglected and Delinquent	2,867,245	2,804,318	-62,927
123-0890	Title I- Comprehensive School Reform	27,680,353	0	-27,680,353
123-0890	Title V – Innovative Programs	24,693,735	12,321,975	-12,371,760
125-0890	Title III - Migrant Education	126,874,549	125,572,326	-1,302,223
125-0890	Title III – Language Acquisition Grants	149,565,827	159,425,032	9,859,205
126-0890	Title I (Part B) - Reading First Grants	146,981,710	145,383,383	-1,598,327
136-0890	Title I (Part A) – Basic Grants & School Improvement Set Aside	1,776,542,957	1,727,346,107	-49,196,850
136-0890	Even Start	27,702,424	11,860,068	-15,842,356
136-0890	Homeless Education	8,606,995	8,309,649	-297,346
137-0890	Rural/Low-Income School Program	1,718,545	1,701,360	-17,185
156-0890	Adult Education	81,382,526	80,633,745	-748,781
161-0890	Special Education-Entitlement Grants & Program Improvement	1,132,572,659	1,130,940,237	-1,632,422
	Special Education-Preschool	39,160,720	38,677,085	-483,635
166-0890	Vocational Education & Tech. Prep.	140,318,604	138,898,803	-1,419,801
180-0890	Education Technology	65,556,713	35,076,910	-30,479,803
183-0890	Safe and Drug Free Schools	52,742,911	41,539,958	-11,202,953
193-0890	Title II (Part A) Math & Science Partnerships	24,513,072	25,055,985	542,913
195-0890	Title II (Part A) – Teacher Quality Grants & State Activities	339,448,010	335,691,360	-3,756,650
197-0890	21st Century Community Learning	137,174,714	131,320,892	-5,853,822
Totals		4,372,940,399	4,219,454,381	-153,486,018

As indicated above, most programs will be reduced by at least 1.0 percent in 2006-07 – consistent with the government-wide rescissions bill for discretionary programs. There are some exceptions. Special Education decreases equate to 0.2 percent (\$1.6 million) because the one-percent reduction was applied to the proposed increase for the program. This reduction reverses significant federal increases for this program in recent years. Between FFY 2001 and 2005, federal Special Education funding grew between \$60 and \$152 million annually.

Several other federal programs will be reduced beyond 1.0 percent in 2006-07. Title I Basic Grant & School Improvement funding – one of the largest federal programs -- decreases by \$49.2 million or 2.8 percent. Five other programs are slated for significant proportional cuts: Education Technology State Grants decreased by \$30.5 million (46.5 percent); State Grants for Innovative Programs decreased by \$12.4 million (50.1 percent); Even Start decreased by \$15.8 million (57.2 percent); and Safe & Drug Free Schools decreased by \$11.2 million (21.2 percent). Funding for the Comprehensive School Reform program is eliminated, resulting in a loss of \$27.7 million.

Two federal programs will actually increase in 2006-07 -- Language Acquisition State Grants grow by 6.6 percent (\$9.9 million) and Math and Science Partnerships grow by 2.2 percent (\$542,913).

The U.S. Department of Health and Human Services has not provided updated state estimates for child care and development programs to states for FFY 2006. Funding changes are not expected for child nutrition (school meals) funding from the U.S. Department of Agriculture since this is an entitlement program and not subject to funding reductions in the federal FFY 2006 appropriations bills.

COMMENTS: Staff notes that funding decreases will play out differently for various federal programs in California in 2006-07. Several programs will be cut significantly below their 2005-06 levels. The Department of Education has identified available federal carryover funds that will mitigate funding reductions for some federal programs on a one-time basis and will be considered in budget adjustments at May Revise. In contrast, other programs -- Title I-- School Improvement, Reading First, Migrant Education and 21st Century Learning Centers -- will continue large carryover balances. While federal funds remain available for 27 months after appropriation, it has been difficult for some of these programs to expend funds within this time period. The Governor's Budget includes proposals that utilize these carryover funds. The Subcommittee will consider these proposals in future hearings.

QUESTIONS:

- 1. How will the loss of approximately \$154 million in federal funds for K-12 education programs in California affect our schools?*
- 2. How should the state respond to the loss of these federal funds?*
- 3. How can federal carryover be maximized in the state budget to mitigate federal grant losses in 2006-07 and beyond?*
- 4. What is the outlook for federal funds in FFY 2007?*

OUTCOME:

Appendix A.

Funds for State Formula – Allocated and Selected Student Aid Programs U.S. Department of Education California

<http://www.ed.gov/about/overview/budget/statetables/07stbystate.pdf>